The Fed Wants to Crush Inflation, But at What Cost?

Following a higher-than-expected inflation print and the Fed's latest rate hike, what are the potential implications for fixed income and equities?

Nanette Abuhoff Jacobson
Managing Director and Multi-Asset Strategist at Wellington Management and Global Investment Strategist for Hartford Funds

Fixed-income investors have experienced a once-in-a-career market correction: a 15% decline in the Bloomberg US Aggregate Bond Index[1] through the first nine months of 2022, in combination with a 24% US equity market sell-off. In the current inflationary environment, fixed income has clearly not played its traditional protective role.

Rising interest rates, triggered largely by higher and stickier inflation than expected, and a scramble by the US Federal Reserve (Fed) to rein in inflation before a vicious cycle of surging wages and even higher prices takes hold, have been drivers of the rout. What now? Ultimately, inflation will determine the path of rates going forward. However, here are three considerations that could support a contrarian view in favor of fixed income:

1. How much monetary policy tightening is already priced in?
A lot. As **FIGURE 1** on page 2 illustrates, according to futures markets, many investors anticipate that the federal funds rate[2] will reach 4.6% by mid-2023, some 200 basis points[3] higher than its current range of 3.00%–3.25%.

2. Is the economy responding to higher interest rates?
To a degree. A bellwether index of US financial conditions has already dropped in response to this year's spike in rates. The housing sector has cooled, supply-chain pressures have begun to ease, and the strong US dollar is disinflationary. Wages and shelter costs have continued to rise.

3. What will it take for the Fed to step back from tightening?
Weaker demand and lower inflation. Fed Chair Jerome Powell has said it would likely take several months of lower core inflation for the Fed to consider retreating from hiking rates. However, a pattern of rising unemployment and below-trend growth could cause the Fed to pause rate hikes.

What Could Go Wrong from Here?

The Fed is in uncharted territory given the gap between current inflation (over 8%) and the Fed's 2% target. Moreover, the Fed's use of quantitative tightening to pare back its balance sheet, simultaneously with outright rate hikes, is untested. While the Fed is hoping its rate hikes will bring down inflation with only "some pain to households and businesses," a deeper recession is a possibility. On the other hand, if the Fed pulls back and the market doesn't believe inflation is under control, the Fed's credibility would be at risk. In that scenario, inflation expectations could become "de-anchored," pushing the 10-year US Treasury yield higher still.

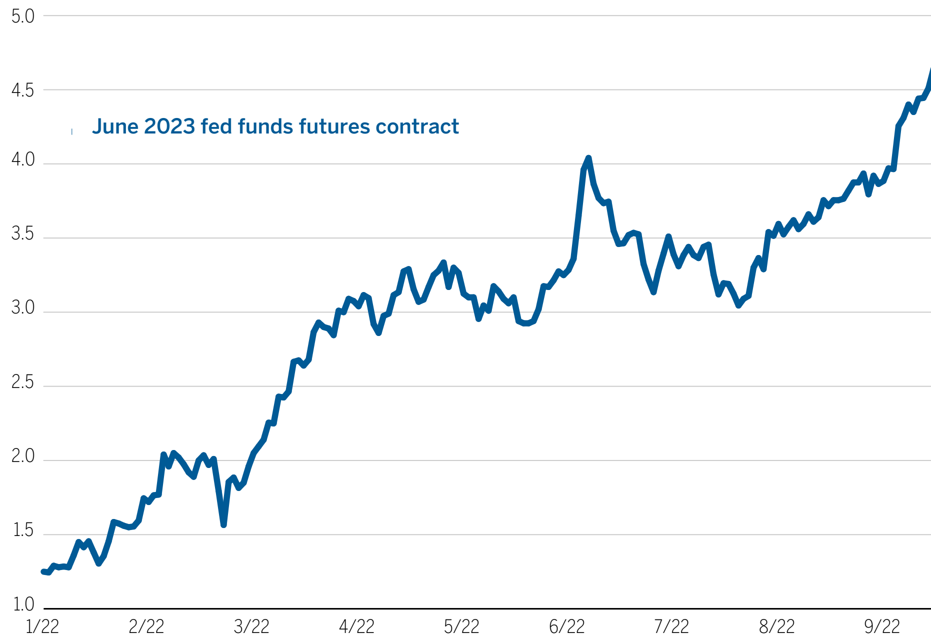
Key Points

- Rising interest rates, triggered by persistent inflation and the Federal Reserve's response, have been drivers of the recent fixed-income rout.
- Some parts of the economy have begun responding to higher interest rates, including the housing sector, supply chains, and the US dollar.
- While the Fed is hoping its rate hikes will bring down inflation with only "some pain to households and businesses," a deeper recession is a possibility.

FIGURE 1

Markets Expect the Fed to Hike Rates to Around 4.6% By Mid-2023

Expected federal funds rate (1/6/22-9/22/22)



Data is shown as mid yield to maturity. Source: Bloomberg, 9/22.

Investment Implications

- **Consider sticking with fixed income at these levels.** In an environment in which the Fed is trying to crush inflation, even at the expense of below-trend growth, I think 10-year US Treasuries sporting around a 3.5%–4% yield could represent decent value for investors and may provide some portfolio diversification if the economy slows, especially given the longer-term structural impediments to growth.
- **Consider diversifying fixed-income exposure.** Given the uncertain inflation outlook, committing too much capital to long-duration[3] US fixed income may be risky. Diversifying across global bond markets and currencies with flexibility to tweak portfolio duration as needed may be a better strategy. High-quality corporate bonds look relatively attractive as of this writing, as do short-term bond yields at today's levels.
- **Quality may be key for equities.** Defensive sectors and dividend payers could outperform the market amid elevated volatility as the Fed removes liquidity in the months ahead. Longer term, many investors may find opportunities in high-quality companies with solid balance sheets and growing revenues and profits at potentially attractive entry points—including in less-favored sectors like technology and consumer discretionary.

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For more information on how rising interest rates can impact your investments, talk to your financial professional.

[1] Bloomberg US Aggregate Bond Index is composed of securities from the Bloomberg Government/Credit Bond Index, Mortgage-Backed Securities Index, Asset-Backed Securities Index, and Commercial Mortgage-Backed Securities Index.

[2] The federal funds rate is the target interest rate set by the Federal Open Market Committee. This target is the rate at which commercial banks borrow and lend their excess reserves to each other overnight.

[3] A basis point is a unit that is equal to 1/100th of 1% and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indices and the yield of a fixed-income security.

[4] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

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